Audit's® NEWS ANALYSIS OF SECURITIES OF REAL ESTATE INVESTMENT TRUSTS

Realty Trust Review

October 10, 1980 VOL. XI, No. ~~20~~ 19

INVESTMENT STRATEGY AND SELECTION ISSUE

NAREIT CONVENTION: ANALYSTS BULLISH ON REIT STOCKS BUT CAUTION IS WARRANTED

The NAREIT (National Association of REITs) convention in Los Angeles was held against a backdrop of the boomy LA real estate market: office and industrial rents are leapfrogging and during the convention one Beverly Hills condo advertised a penthouse for $11,000,000, complete with a Rolls Royce bonus to the buyer. Sessions opened with a special meeting of the Los Angeles Society of Security Analysts where opinions ranged from bullish to euphoric.

Richard Lilly of the St. Petersburg, Fla. brokerage of Raymond James & Associates, said the revitalized REITs stood out as "an alternative investment medium of rare importance...The attraction is REITs with assets on their books at far below replacement costs." He cited trusts with apartments on their books at $12,000-$15,000 per unit, office and shopping center space at $20-$25 per square foot, and office space vacancies a rarity. Lilly has already authored favorable reports on Hospital Mortgage Group, Inc. and ICM Realty, both No. 1-Ranked, and his comments indicated more favorable recommendations may be on the way. But Lilly said he has very little interest in REITs generating new equity investments because yield on the new investments may dilute the existing "near bond-type return," which he believes can about double for many trusts over the next five years.

Bruce Garrison, institutional analyst for Underwood Neuhaus & Co. of Houston saw institutional interest in REITs improving, albeit from a low base. He outlined a favorable economic environment that included a Washington bias to stress investment over consumption, a hint the capital gains tax may be cut to 20% (from 28%), and Federal Reserve Board determination to keep the money supply under control. Taken together, they could spell a significant lowering of yield requirements that, coupled with growth by REITs, could "be absolutely staggering to share prices." Today trusts operate in a "landlord's market"

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PUBLISHED TWICE MONTHLY ON THE SECOND AND FOURTH FRIDAYS SUBSCRIPTIONS $164 ANNUALLY SINGLE COPY $10 (RELATIVE APPEAL $20) RECENT BACK ISSUES $2.00 TO NON-TRIAL SUBSCRIBERS

and seasoned managements, veterans of the 1974-75 real estate recession, may be the biggest hidden asset. He was concerned that investors might count on inflation generating a significant amount of total return. He named no names.

Werner Keller, whose Albion Management handles money for substantial investors, said he agreed "more so" with his colleagues, but cautioned "when a general feeling is abroad, be wary." He recalled that in 1972, when he was with a specialized REIT fund, he had addressed the NAREIT convention on "how to pick REIT winners," when most REITs were stressing short-term mortgages. Now most REITs are stressing equities, but "at some point we will get risk in equities." His investing approach is to be opportunistic in smaller stocks, especially depressed stocks. The two plays he likes now are pure interest plays, because he can integrate them with his own interest rate forecast, and smaller recovery entities where he sees insider buying and some sophisticated investor interest via 13-D filings. Interest rate plays mentioned were Equitable Life Mortgage, Realty ReFund, and Wells Fargo Mortgage and Equity Trust; recovery situations he named were Cameron-Brown Investment Group, Compass Investment Group, First Newport Corp., North American Mortgage Investors, and TIERCO.

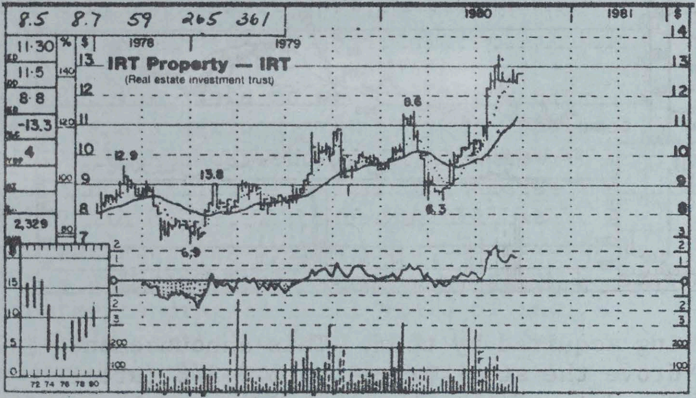
During convention sessions, James Donohue of Merrill Lynch, White Weld, said he was "quite optimistic" about the outlook for REIT financing and said the $222 million raised by REITs through September was the highest total in years and continued a steady rise in offerings, especially of equities. But he felt that any long-term money would have to carry an equity feature, or kicker, in today's market. Both convertible debt and convertible preferreds were seen as main financing vehicles.

Richard Frary, corporate finance specialist for Drexel Burnham Lambert, found "most significance in the tremendous interest in obtaining control of a REIT vehicle." Many sophisticated investors seek this route because they feel shares are selling below perceived liquidation value, they believe they can get leverage through controlling large amounts of assets, and they can get access to long-term capital. But Frary also said he believed many REIT managements were undervaluing their net operating loss carryforwards and noted that one recently announced deal was implicitly valuing NOL at about 20% of face amount, much higher than in previous deals. He singled out pending deals involving BT Mortgage, Midland Mortgage, TIERCO, Republic Mortgage and Plaza Realty as having some taxloss features.

Frary saw the advent of paired stocks as a source of new activity and interest in REITs, both for qualified REITs pairing with their investment advisers/managers (e.g., Hotel Investors) and existing companies putting their investment properties into a new REIT whose stock is then paired in trading with the sponsor (e.g., Santa Anita Realty).

And representatives of both types of potential pairs were in evidence at the convention. Officers of Cenvill Communities (37-1/2 - ASE) and United National Corp. (8-1/2 - ASE) both attended; Cenvill, a major Florida retirement community developer has announced plans to become a paired REIT while United National said it's studying the idea. Among qualified REITs, Washington REIT's holders have approved the principle of pairing and the fact WRIT's stock hit an all-time high of 41-1/4 this week (ASE) may indicate a favorable IRS ruling is near. Meantime IRT Property Co. (12-3/8 - ASE) indicated it is right behind WRIT for a similar IRS ruling. If approved, self-managed IRT could create a separate company to sell three apartment projects with over 900 units as condos while retaining some of the profits. Such a gambit could add $2-$4 to IRT's $13.59/sh. adjusted book value over

two-three years. We're raising IRT's shares to No. 1 Ranking based on this prospect.



But not everyone was into the bullish swing. Martin Bucksbaum, the quiet architect of General Growth Properties's strategy of developing mall shopping centers in stable Midwestern farm belt cities, cautioned that his leasing people were finding many smaller retailers unwilling or unable, because of high interest and carrying costs, to commit to current rents. Result: three GGP centers soon to open will begin with up to 40% of space uncommmitted, and leasing may take one-two years. Shopping center values are still there but will take longer to realize, he said. That message is why No. 1-Ranked GGP shares (19-1/2 - NYSE) have been indifferent performers since a $15/sh. dividend was paid in June after most mature centers were sold. And it's why we think the bullish optimism that permeated the NAREIT convention has to be tempered by investors. It's a time to stay selective.

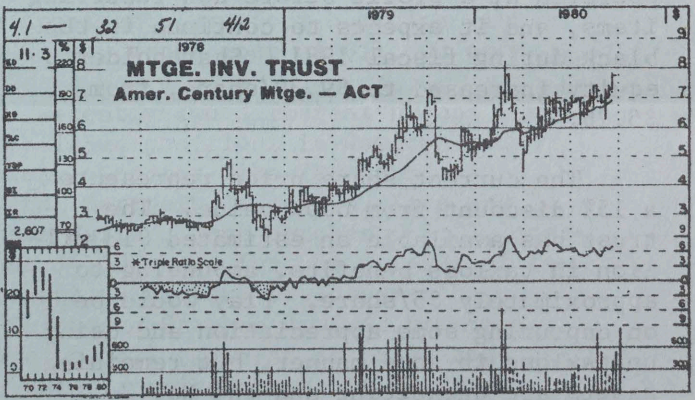
LOOKING FOR BARGAINS: SEVEN STOCKS GOING FOR LESS THAN TEN DOLLARS

With the runup in realty trust prices, the investor is harder and harder pressed to find worthwhile stocks selling for less than $10, i.e., stocks that the smaller investor can purchase in round lots without commiting too large a portion of his available assets. And there's another cogent reason for seeking out such stocks. As we pointed out two weeks ago, gains registered by most of the qualified REITs, which are the highest priced realty trust stocks generally, have begun to slow, while more speculative money continues to fan the flames of the nonqualified trusts.

Without putting too fine a point on it, the higher priced stocks tend to reflect already exploited situations and higher investor interest. While we would never make the tautology that high stock price equals full value while a low price equals a bargain, we do think that it's worthwhile to explore lower priced stocks for potentially unexploited values.

For this issue we ran the following screen. First, we decided to consider only New York and American Stock Exchange-listed trusts, in order to insure a certain amount of visibility. Then, we decided that stocks falling in the $5 to $10 range were best suited to our purpose, as they provided a reasonable amount of value and stability--small ticks do not represent such a large proportion of the stock price.

This resulted in a list of 12 realty trust stocks out of our list of 125 ranked stocks. Five of them--Mission Investment, MONY Mortgage, Realty ReFund, State Mutual, and Security Capital--had been reviewed in RTR within the last six months, leaving us with seven. Here are the results:



American Century Trust (8, NYSE), formerly American Century Mortgage, "turned the corner" in its fiscal year ended June 30, 1980. The trust sold its largest asset, the Century Building in Arlington,

Virginia, carried at a gross cost of $23 million, and another Arlington office building carried at $11 million. The trust realized a gain of $4.3 million on the sales, and total sale gains of $7.6 million ($2.93/share) for the year.

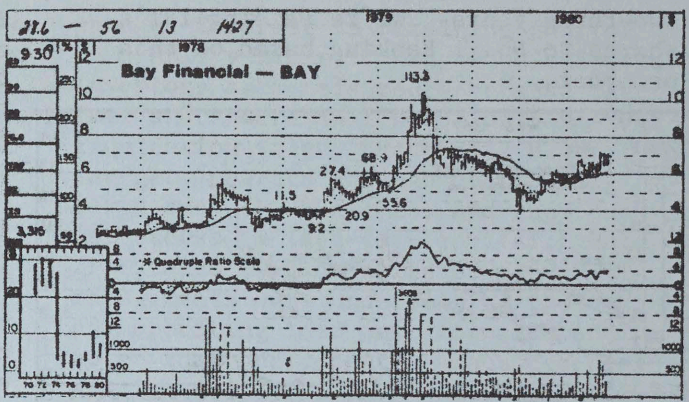
Proceeds from sales were used to cut bank debt from $39 million to $8 million, accruing at the lower of 10% or prime, and due December, 1981. Other debt is $11 million of 6-3/4% and 7% debentures due 1991 and 1990. The investment portfolio is now $19 million earning mortgage loans, $15 million foreclosed properties, including $11 million non-earning, and $14 million equity investments, including $1.5 million land purchase leasebacks.

The sole rental property is a 400-unit motor hotel in Arlington, providing a minimum annual rental of $825,000. There are two operating foreclosed properties, a 104-unit apartment complex in Hilliard, Florida, carried at $1 million, and a $3 million 86,500 square foot office building in St. Petersburg, Florida. Other foreclosed properties are mostly land parcels.

The trust lost $61,000, or 2¢/share in fiscal 1980, before sale gains, loss reserve reversal, and taxloss carryforwards resulting in net income of $3.63/-share. In the fourth quarter, the trust operated at a profit before non-recurring items, and it expects to continue in the black during fiscal 1981. Shareholder's equity increased to $9.39/share, from $5.76.

The current share price represents a 15% discount from book value. The trust has available an estimated $13 million in taxloss benefits, amounting to approximately $5/share. Play would be on capturing some appreciation and using up taxloss in some manner, but remaining assets are unexciting and the No. 3-ranked shares less interesting than others.

Bay Financial Corp. (8-3/4, NYSE) revealed late last month that it has had discussions with certain concerns about the possibility of acquiring them or be-



ing acquired by them. This announcement drove the stock price up to 9-3/8 (after the date of the chart), before settling to its current level. This 1980 high remains below the 1979 high of 10-3/8, reached just a little over a year ago, before the October massacre.

At May 31, 1980, the company had a book value of $6.88/share. The investment portfolio amounted to $153 million, of which $108 million was equity investments and the remainder mortgage loans. Equity investments included $31 million of land purchase leasebacks (the company is selling $10 million of these for $13 million), all of which provided contingent interest based on gross receipts. Other investments were $29 million of completed properties ($10 million non-earning), $22 million of construction in progress, and $26 million of land.

Included under the construction in progress category is Bay Financial's largest single investment, amounting to a gross cost of $20 million, the 366-unit Plymouth Tower apartment building at 340 East 93 St. in New York City. Nearly half rented by mid-August, the building is expected to be fully occupied by 1980 year-end. Once this is achieved, the company projects a return of 18% on its investment. At that rate, the company would be expected to hang on to the building; eventual conversion to a co-op remains a possibility.

The company's second largest single investment ($15 million), the Sheraton Newport Hotel in Newport Beach, California, also provides a more than satisfac-

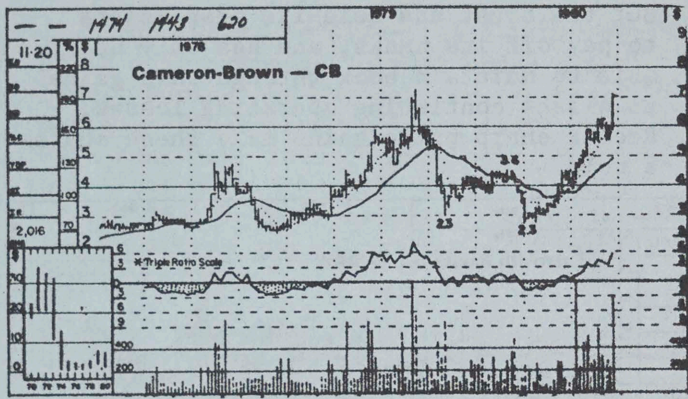
tory yield. In the fiscal year ended May 31, 1980, the hotel returned 19% cash on the company's investment, and is expected to improve on that performance in the current fiscal year.

But the drags on the company's earnings remain serious. At May 31, 1980, earning leasebacks and mortgage loans, including participation income, had a cash yield of 13.2%. Earning real estate was yielding 19.0%. But the effects of $79 million of non- and low-earning investments dragged total yield of the company's portfolio down to 6.5%. In comparison, the cost of the company's debt for fiscal 1980 was 7.2%. For the year, the company lost $1.8 million before sale gains, a reversal of loss reserve and extraordinary items resulting in net income of $1.7 million, or 50¢/share.

Bay Colony is in a long workout situation. The company's development activities to facilitate assets sales and liquidate debt (about $18 million due in the next year and a half), while proceeding successfully, will be slow to finish; too, the portfolio of mortgage loans mostly yielding from 7% to 10% is ten years from being substantially liquidated. But the Plymouth Tower should give a good kick to cash flow, and the geographically diverse portfolio provides both good income properties (22% office buildings and 14% hotels) plus properties with attractive liquidation potential if desired (17% earning apartment, excluding Plymouth).

DVM Inc., a California real estate investor and developer, owns 7.5% of the shares, increasing the likelihood of an eventual merger/acquisition of some form. But even absent this, the current share price represents an attractive discount from probable fair market value and potential appreciation. The No. 2-ranked shares are an attractive long-term commitment.

Cameron-Brown Investment Group (7-1/4, NYSE) has spent the last several years swapping and selling assets to pay off its bank debt from a peak of $120 million in



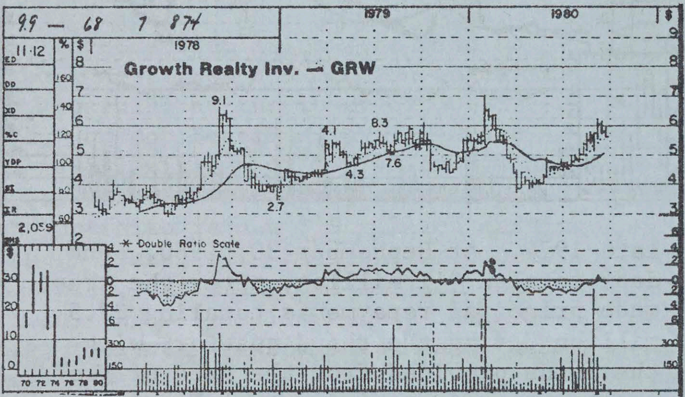
late 1974. At September 30, 1980, bank debt totaled $11 million, after the trust made principal repayments totaling $7.5 million during the third quarter, with the funds provided from the sale of two apartment projects in central Florida with 420 units, and two land parcels, in Texas and Florida. The trust is paying prime plus 2% up to 15%, with a cash rate of 10%; in 1981, the cash rate will rise to the stated rate. The debt is to be retired by December 31, 1981.

Following the sales, the trust is left with a portfolio of about $36 million, consisting of $14 million mortgage loans ($12 million earning); $15 million in forclosed land (57%) and apartment buildings (43%); $3 million real estate under sale contract; and $4 million real estate under development. Trust properties are located mostly in Florida, Georgia, North Carolina, and Maryland. Remaining apartments are four building with 730 units, gross cost of $11,800/each.

Recently two different groups have established positions in Cameron-Brown shares. Charter Oaks Partners, with general partners Jerrold N. Fine and Robert Jaffee, have purchased 7.0%, mostly at $4.50/share for the purpose of investment. New York businessmen Marshall S. Cogan and Stephen C. Swid have purchased a 5.2% interest at an average price including commissions of $4.29/share. They are considering seeking representation on the trust's board for direct or indirect control.

Trust shares still sell at a discount from book value at June 30 of $9.36/share.

But the trust has sold its best assets to pay off its banks, and has only been able to maintain book through sale gains to offset continuing operating losses. Recent sharp price gains make these shares a hold.

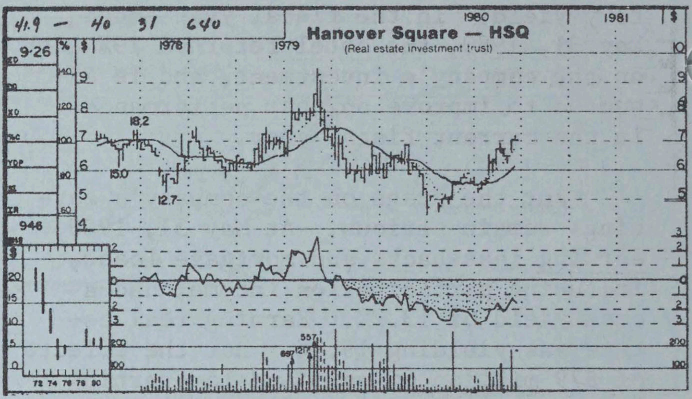


Growth Realty Cos. (5-3/4, NYSE) has made its first move to becoming a national realty and mortgage broker, with its recent agreement in principle to acquire Moran Co., an Alhambra, California-based real estate development, management and construction firm in exchange for a 10% interest in Growth Realty.

The company's recovery has been hampered by slowing property sales earlier this year, but in recent months it had turned around. In June, 1980, it sold a Houston apartment building for a $1.2 million gain, which, with an earlier sale had enabled it to use up the $4.9 million in taxloss carryforwards which expired in its June 1980 year.

At year-end, share book value totaled $7.50; during the year, Growth realized $3 million of the $14 million appraised value in excess of book. A new appraisal of remaining assets estimated excess value to have risen to $14.4 million, or $7 over book.

Current problems are $36 million bank debt (June, 1980) and continuing operating losses. Debt must be cut to $20 million at 1980 year-end and eliminated at December, 1981. But success in capturing asset appreciation and creative management point to long-term realization of values, and at the current price, the No. 2-ranked shares are an attractive purchase.



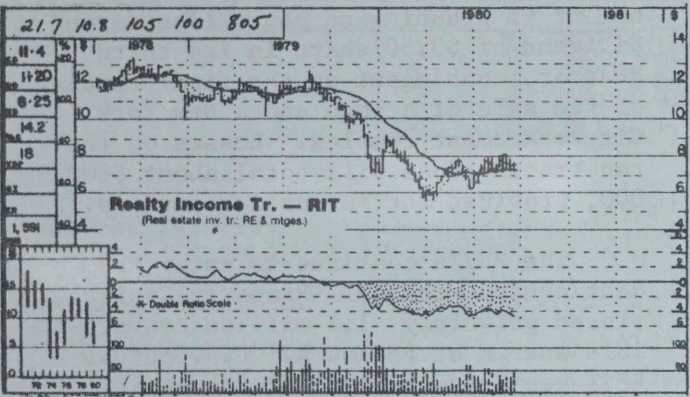
Hanover Square Realty (6-5/8, ASE) has been successful in divesting most of its foreclosed properties, but gains were wiped out by a rate of prime plus 2% paid on its $9 million bank debt, due June, 1981. As a result, the share price has remained well below its 9¼ high reached in September, 1979, and the trust has continued to report operating losses.

The most significant recent developments have been shareholder approval of deREITing, which will enable the trust to expand its ange of activities, and the sale of most of Cooper Labs' 35% interest. Madison Fund, Inc., purchased a 10% interest, and Pearce, Mayer & Greer Inc., the trust's adviser, bought about 6%, with an option to acquire 10% more. The trust acquired its adviser for shares; PMG will end up with about a 30% interest.

The discount from book value of $11.38 is illusory, especially if interest rates creep up, since Hanover Square must sell mortgages to pay off its banks. The No. 3-ranked shares are a speculation on lower rates, deREITing, and the effective buying back of shares, but remain a less attractive value.

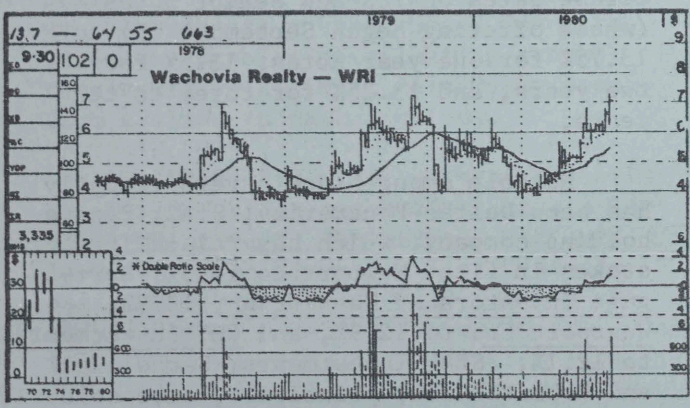
Realty Income Trust (6-7/8, ASE) is the only dividend paying, qualified REIT among this group. Here too, costs of $20 million floating rate bank debt outweighed the effects of improvements in the portfolio. The trust lost 48¢/share in its April, 1980, fiscal year; dividends totaling $1.10/share were 95% taxfree return of capital and 5% capital gains.

Realty Income's $51 million portfolio



is 27% equity investments, mainly land purchase leasebacks. The future course for the trust will entail liquidating its lower earnings mortgages to pay off its banks, eventually leaving it with a portfolio of equity investments and high rate mortgages, leveraged by mortgage debt.

Current indicated yield on the shares is 11.6%. Hazards are the bite of debt servicing and the erosion of book value by the maintenance of that rate. But the shares, now selling near their all-time low, make an interesting, albeit somewhat speculative income vehicle, to be purchased through a rate peak.



<u>Wachovia Realty Investments</u> (6½, NYSE) is in the process of eliminating its foreclosed properties. A $12 million Farmington, Conn. complex was sold in the August fourth quarter and it expects to close the sale of a $6 million Atlanta apartment by month-end, which will leave it with $7 million in land. Foreclosed properties will drop to 15% of investments from 37%; the remainder is mostly earning mortgages.

The trust had $17 million bank debt at 1% over prime at July 31 under a new line. During the May quarter, earning mortgage loans were yielding 14.9%, so with bank debt reduced with sale proceeds, the trust should be able to use up some of its $$5.25/share taxloss. The No. 2-ranked shares can be purchased if rates start to fall.

<u>REITS IN THE NEWS: CITIZENS MORTGAGE SUIT, METROPLEX PROXY, NEW OFFER FOR REPUBLIC</u>

The reorganization trustee for <u>Citizens Mortgage Investment</u> is suing Manufacturers Hanover Mortgage Corp., the trust's former manager, Touche, Ross & Co., the former auditors, and several individuals.

The suit alleges that the manager caused the trust to go bankrupt, including among the charges that they "failed to adequately investigate and analyze Loan proposals," that loans were "doubtful and precarious," and "not in accordance with the authorizations." One particular loan was "predicated primarily upon an unrealistic evaluation of the value of the stock in the corporate borrowing entity;" another was to an entity which was "on the verge and in the process of collapse."

Touche, Ross is charge with performing its services "in a negligent, reckless, careless, unskilled and grossly negligent manner."

<u>Metroplex Realty</u>, whose bankruptcy plan was approved in May, 1979, has finally filed its proxy for shareholder approval of the conversion of Metroplex shares into shares of Vista Mortgage & Realty, Inc., through a ten-for-one reverse split.

The bankruptcy plan had called for a five-for-one reverse split; trustees decided that a ten-for-one split was more appropriate. This will result in book value as of March 31, 1980, of about $5/-share. Since that date, the trust has sold a Brownsville, Texas, shopping center for $450,000, or $150,000 over book, and has executed a sales contract for its 6.8% interest in a South Padre, Texas,

land parcel for $350,000, or $150,000 over book.

With the change to corporate form, the trust is considering entering the mortgage servicing business; it will continue to liquidate its assets. But at this point, the importance to current shareholders is the reverse split, since those shares which had been issued to debenture holders will finally be registered and sellable.

Republic Mortgage has received yet another bid from the Oppenheimer group, to top the latest offer from Roland International. Now the Oppenheimer group is offering to swap its New York City apartment building with a guaranteed realized value of $7.5 million for only 1.5 million Republic shares, giving them a value of $5 each. Formerly, the shares were valued at $4 each. An additional 1.5 million shares would be placed in escrow to be released to the group over five years according to a formula based on the trust's earnings and assets. This transaction would result in a 42% interest in Republic to start, escalating up to 59%.

Republic's board accepted this offer, rejecting Roland's third offer to exchange a Colorado condo project plus $6 million cash for 3 million shares, with 1.5 million additional shares placed in escrow. Roland wanted majority representation on Republic's board, but Oppenheimer will accept a minority representation.

Denver REIA may postpone next week's shareholder meeting to vote on the sale of its assets to Romanek, Golub & Co. for $34/share. First City Holdings, a group of Canadian investors, has said that it will not tender for trust shares at $35 each; however, it has offered to purchase the assets for $36/share, and without the $2/share six-month warranty escrow entailed in the sale to Romanek,Golub.

Other news on the liquidation front includes Ryan Mortgage Investors' proposal to liquidate; shareholders will vote early in 1981. Citinational Development is planning to pay a liquidating dividend of $3.50/share in its third quarter, contingent on the final funding of the sale of a loan and a New York City apartment complex. Losses on the two transactions will total about $600,000, provided for in earlier periods.

The REITs continue to enter the debt/equity markets. Property Capital placed privately 1.1 million convertible shares at $22 each. U.S. Mutual REIT has begun a best efforts equity offering designed to raise $35 million through the sale of 3.5 million shares. The trust had 2.6 million shares outstanding prior to the offer; it is the trust's fifth best efforts offering. Proceeds will be used to purchase land installment contracts.

Old Dominion REIT has filed a registration statement with the SEC for the sale of $3 million of 10-year convertible subordinated debentures. Proceeds are earmarked to repay banks and mortgage debt on two properties. Proceeds from refinancing the properties will be used for acquisitions.

B.F. Saul REIT has raised the interest rates on its new senior notes (whose offering began September 18) to 13.75% for one year notes, 13.5% for two years, and 13.25% for three to ten years.

Notable among block buyers recently has been Deltec-Panamerica, S.A., Panama holding company, which has raised its stakes in First Newport to 14.5%, Mortgage Investors of Washington, 13.7%, Westport Co. to 12.9%, and CMT Investment to 12.1%. SZRL Investments, Samuel Zell and Robert Lurie, principals, have sold their 6.8% interest in CleveTrust Realty to Tulip Real Estate and Champion Asset Management, giving them a 22.4% interest. SZRL has bought a 5.6% interest in Great American Management.

Compass Investment Group has announced that it will not proceed with its offer to exchange 16.25% debentures for up to 1 million of its common shares.